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PLR-117362-06

Date: JANUARY 11, 2007

In Re:

LEGEND:

Settlor =

Trust =

Child A =

Child B =

Child C =

A =

B =

C =

Corporate Trustee =

Child A Trust =

Child B Trust =

Child C Trust =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

State =

Court =

Dear _____ :

This is in response to the December 5, 2006 letter and other correspondence requesting rulings on the income, gift and generation-skipping transfer tax consequences of the proposed modification and partition of the Trust.

On Date 1, prior to September 25, 1985, Settlor irrevocably created the Trust for the benefit of his three children (Child A, Child B, and Child C) and their descendants. On Date 2, also prior to September 25, 1985, Trust was amended with the consent of Settlor, the then current trustees, and the trust beneficiaries, Child A, Child B, and Child C. Child A and A, an individual, were originally designated as the trustees. Settlor died on Date 3. Child A, Child B, and Child C are currently living. Each has children and grandchildren.

The pertinent provisions of the Trust are as follows. Article 2.3 provides that during the trust term, the trustees may, in their sole and absolute discretion, make distributions of trust income and/or principal to or for the benefit of Settlor's children as the trustees deem necessary and/or advisable for their care, support, maintenance, welfare, medical and emergency needs. Discretionary distributions shall be made from time to time and at any time in such amounts and manner as the trustees in the exercise of their sole discretion determine best.

Article 2.4 provides that during the trust term, the trustees may, in their sole and absolute discretion, make distributions of trust income and/or principal to or for the benefit of Settlor's grandchildren as the trustees deem necessary or advisable. Discretionary distributions shall be made from time to time and at any time in such amounts and manner as the trustees in the exercise of their sole discretion shall determine best.

Article 2.5 provides that on the death of the last survivor of Settlor's children, the Trust will be divided into separate and equal trust shares, the number of shares being determined by the number of deceased children of Settlor who are survived by lineal descendants. Each such trust share will be held and administered for the benefit of the respective child's (i.e., Child A's, Child B's, or Child C's) lineal descendants. When a beneficiary attains distribution age, a pro rata portion of the trust share will be distributed to him or her outright, and the trust will terminate as to him or her. Under Article 2.5(a), (b), and (c), "distribution age" means age 40 with respect to Settlor's grandchildren living at the creation of the Trust and age 21 with respect to all other beneficiaries. If a beneficiary has attained distribution age at the death of the last survivor of Settlor's children, distribution to that beneficiary is to be made as soon as practical thereafter. If a beneficiary dies before attaining distribution age and before receiving complete distribution of his or her pro rata portion of the trust share, the pro rata portion is to vest in the beneficiary as of his or her death and be distributed as soon as practical after the death of the beneficiary to his or her then living lineal descendants.

Article 5.3 provides that if any person serving as a trustee is simultaneously a beneficiary, the powers of that person, as trustee, shall abate with respect to the exercise of

discretion granted to trustees in making distributions of trust income and/or principal to that person or that person's lineal descendants.

Under Article 10.2 as executed on Date 1, in the event Child A ceases to serve as co-trustee, the following will automatically succeed as co-trustee in the following order: Child B, Corporate Trustee. Under Article 10.3, in the event that A ceases to serve as co-trustee, the following will automatically succeed as co-trustee in the following order: B, C, and Corporate

Trustee. On Date 2, as noted above, Article 10.3 was amended to provide that if Child B ceases to serve as co-trustee, the following will automatically succeed as co-trustee in the following order: Child C, Corporate Trustee.

The trustees propose to partition the Trust into three separate and equal trusts: the Child A Trust, the Child B Trust, and the Child C Trust. Child A will be the trustee of the Child A Trust. Child B will be the trustee of the Child B Trust. Child C will be the trustee of the Child C Trust. The Trust provisions executed by Settlor will govern the Child A Trust, Child B Trust and Child C Trust except for the following modifications.

Article 10.1 will provide that each child is to be the sole trustee of the separate trust named for him or her. Article 10.2 will provide that a child may appoint a co-trustee of his or her separate trust. The co-trustee must be an Independent Trustee. Once a child has appointed an Independent Trustee, an Independent Trustee will be required at all times for that child's trust. The named child may remove the Independent Trustee upon the appointment and acceptance of a successor Independent Trustee.

Article 10.3 will provide that if a child has resigned and is not serving as a trustee of the trust named for him or her, the child may resume the co-trustee position at any time by serving notice upon the then serving Independent Trustee.

Article 10.4 will provide that if the named child ceases to serve as trustee, the Independent Trustee then serving will be sole trustee. If there is no Independent Trustee, Corporate Trustee is to be the Independent Trustee.

Article 10.5 will provide that after the death or total incapacity of the named child (i.e., Child A, Child B, or Child C), the ability to remove and appoint a successor Independent Trustee may be exercised by a majority of the adult beneficiaries of the named child's separate trust.

Article 10.7 will provide that the term "Independent Trustee" means a corporate or individual trustee who is neither "related" nor "subordinate" within the meaning of § 672(c) of the Internal Revenue Code of 1986, as amended, to the person appointing such trustee. If a separate trust has more than one adult beneficiary, any trustee appointed by the adult beneficiaries must be neither related nor subordinate within the meaning of § 672(c) to any of the adult beneficiaries of that separate trust.

The trustees petitioned the Court for approval of the partition. The Court approved the partition in an order dated Date 4. The order is not to be effective unless and until the trustees file with the Court a copy of a favorable letter ruling from the Internal Revenue Service.

You have asked for the following rulings.

- (1) The partition will not cause the Trust or any beneficiary to recognize gain or loss from a sale or other disposition of property under § 61 or § 1001.
- (2) Assuming the Trust is otherwise exempt from Generation-Skipping Transfer Tax, the partition will not result in the Trust losing exempt status under § 1433(b)(2)(A) of the Tax Reform Act of 1986, and will not cause any distribution from, or termination of any interests in, the Trust to be subject to the Generation-Skipping Transfer Tax.
- (3) The partition will not cause any beneficiary to be considered as having made a taxable gift and will not constitute a taxable gift to any beneficiary under § 2501.

Law and analysis:

Issue 1:

Section 61(a)(3) of the Internal Revenue Code provides that gross income includes gains derived from dealings in property and, under § 61(a)(15), from an interest in a trust.

Section 1001(a) provides that the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in § 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in § 1011 for determining loss over the amount realized.

Section 1001(b) states that the amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received. Under § 1001(c), except as otherwise provided in subtitle A, the entire amount of gain or loss determined under § 1001 on the sale or exchange of property shall be recognized.

Section 1.1001-1(a) of the Income Tax Regulations provides that gain or loss realized from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or in extent, is treated as income or loss sustained.

A partition of jointly owned property is not a sale or other disposition of property where the co-owners of the joint property sever their joint interests but do not acquire a new or additional interest as a result of the transaction. Thus, neither gain nor loss is realized on a

partition. See Rev. Rul. 56-437, 1956-2 C.B. 7.

Cottage Savings Ass'n v. Commissioner, 499 U.S. 554 (1991), concerns the issue of when a sale or exchange has taken place that results in realization of gain or loss under §1001. In Cottage Savings, a financial institution exchanged its interests in one group of residential mortgage loans for another lender's interests in a different group of residential mortgage loans. The two groups of mortgages were considered "substantially identical" by the agency that regulated the financial institution.

The Court concluded that § 1.1001-1 reasonably interprets § 1001(a) and stated that an exchange of property gives rise to a realization event under § 1001(a) if the properties exchanged are "materially different." Cottage Savings, 499 U.S. at 560-561. In defining what constitutes a "material difference" for purposes of § 1001(a), the Court stated that properties are "different" in the sense that is "material" to the Code so long as their respective possessors enjoy legal entitlements that are different in kind or extent. Cottage Savings, 499 U.S. at 564-44. The Court held that mortgage loans made to different obligors and secured by different homes did embody distinct legal entitlements, and that the taxpayer realized losses when it exchanged interests in the loans. Cottage Savings, 499 U.S. at 566.

We note that the submission's facts and the petition to the Court state that the "Trust estate shall be equally divided into three fractional shares of equal value." This is not necessarily the same as a "pro rata" partition of each of the Trust's assets and the pro rata distribution of such assets into the three resulting separate trusts. However, the submission does indicate that the division will be pro rata. Further, Paragraph 10 of the Date 4 order issued by the Court approving the partition specifically states that "[e]ffective the Partition Date *each of the assets of the [Trust] should be equally divided* among the three resulting trusts in fractional shares. If any asset cannot be equally divided in ownership, then it shall be sold and the resulting cash shall be distributed equally among the three resulting trusts." [Emphasis added.] This language equates to an order by the Court that the assets in the Trust corpus be divided and distributed among the Child A Trust, the Child B Trust, and the Child C Trust on a pro rata basis.

It is consistent with the Supreme Court's opinion in Cottage Savings to find that the legal entitlements and interests of the beneficiaries of each of the resulting separate trusts will not differ materially in kind or extent from their interests in the Trust. Except for the modifications described above, all relevant provisions of the Trust will remain unchanged. Accordingly, no gain or loss is recognized on the partition of the trust for purposes of § 1001(a) by the Trust or any of the three resulting separate trusts or any beneficiary of those trusts.

Issue 2:

Section 2601 imposes a tax on each generation-skipping transfer made by a transferor to a skip person.

Under § 1433(a) of the Tax Reform Act of 1986, the generation-skipping transfer tax is generally applicable to generation-skipping transfers made after October 22, 1986. However, under § 1433(b)(2)(A) of the Tax Reform Act and § 26.2601-1(b)(1)(i) of the Generation-Skipping Transfer Tax Regulations, the tax does not apply to a transfer from a trust, if the trust was irrevocable on September 25, 1985, and no addition (actual or constructive) was made to the trust after that date. Under § 26.2601-1(b)(1)(ii), any trust in existence on September 25, 1985, will be considered irrevocable unless the settlor had a power that would have caused inclusion of the trust in his or her gross estate under § 2038 or § 2042, if the settlor had died on September 25, 1985.

Section 26.2601-1(b)(4)(i) provides rules for determining when a modification, judicial construction, settlement agreement, or trustee action with respect to a trust that is exempt from the generation-skipping transfer tax will not cause the trust to lose its exempt status. The regulation provides that the rules contained in the paragraph are generally applicable only for purposes of determining whether an exempt trust retains its exempt status for generation-skipping transfer tax purposes. Unless noted otherwise, the rules do not apply in determining, for example, whether the transaction results in a gift subject to gift tax, or may cause the trust to be included in the gross estate of a beneficiary, or may result in the realization of capital gain for purposes of § 1001.

Section 26.2601-1(b)(4)(i)(D) provides that a modification will not cause an exempt trust to be subject to the provisions of chapter 13, if the modification does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation (as defined in § 2651) than the person or persons who held the beneficial interest prior to the modification, and the modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust. A modification of an exempt trust will result in a shift in beneficial interest to a lower generation beneficiary if the modification can result in either an increase in the amount of a GST transfer or the creation of a new GST transfer. A modification that is administrative in nature that only indirectly increases the amount transferred (for example, by lowering administrative costs or income taxes) will not be considered to shift a beneficial interest in the trust.

Example 5, contained in § 26.2601-1(b)(4)(i)(E), considers a situation where, in 1980, Grantor established an irrevocable trust for the benefit of his two children, A and B, and their issue. Under the terms of the trust, the trustee has the discretion to distribute income and principal to A, B, and their issue in such amounts as the trustee deems appropriate. On the death of the last to die of A and B, the trust principal is to be distributed to the living issue of A and B, per stirpes. In 2002, the appropriate court approved the division of the trust into two equal trusts, one for the benefit of A and A's issue and one for the benefit of B and B's issue. The trust for A and A's issue provides that the trustee has the discretion to distribute trust income and principal to A and A's issue in such amounts as the trustee deems appropriate. On A's death, the trust principal is to be distributed equally to A's issue, per stirpes. If A dies with no living descendants, the principal will be added to the trust for B and B's issue. The

trust for B and B 's issue is identical (except for the beneficiaries), and terminates at B 's death at which time the trust principal is to be distributed equally to B 's issue, per stirpes. If B dies with no living descendants, the principal will be added to the trust for A and A's issue. The division of the trust into two trusts does not shift any beneficial interest in the trust to a beneficiary who occupies a lower generation (as defined in § 2651) than the person or persons who held the beneficial interest prior to the division. In addition, the division does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust. Therefore, the two partitioned trusts resulting from the division will not be subject to the provisions of chapter 13.

Rev. Rul. 95-58, 1995-2 C.B. 191, concludes that a settlor's retained power to remove a trustee and appoint an individual or corporate trustee as successor that is not related or subordinate to the settlor (within the meaning of § 672(c)), will not be considered a retention of the trustee's discretionary powers for purposes of §§ 2036 and 2038.

In the present case, the Trust was irrevocable on September 25, 1985. It is represented that no trust additions have been made after September 25, 1985.

The proposed partition of the Trust into the Child A Trust, the Child B Trust, and the Child C Trust is substantially similar to the situation described in Example 5 of § 26.2601-1(b)(4)(i)(E). Under the proposed modification and partition, these trusts will, except as described above, be administered under the original terms of the Trust.

Further, although each of Child A, Child B, and Child C will be appointed the trustee of his or her respective trust, under Article 5.3, each will be foreclosed from making any distributions of trust income or corpus to any trust beneficiary (the respective child and his or her descendants). In order for a trust distribution to be made, Child A, Child B, or Child C, as the case may be, must first appoint an "Independent Trustee," defined as an individual or corporation that is neither related or subordinate (within the meaning of section 672(c)) to any adult beneficiary of the trust. Under the modified trustee successor provisions, Child A, Child B, and Child C each have the power to remove and replace the Independent Trustee. If removed, that trustee must be replaced with another Independent Trustee. In the event of the death or total incapacity of the named child, the adult beneficiaries of the child's trust will also have the power, by a majority vote, to remove and replace the Independent Trustee. If removed, that trustee must be replaced with another Independent Trustee. The removal and replacement power satisfies the standards of Rev. Rul. 95-58.

Consequently, we conclude that: (1) the partition of the Trust into the Child A Trust, the Child B Trust, and the Child C Trust, and (2) the trust modification relating to the appointment of an Independent Trustee will not result in a shift of any beneficial interest in the Trust assets to any beneficiary who occupies a generation lower than the persons holding the beneficial interests prior to the partition and modification. In addition, the partition and modification will not extend the time for vesting of any beneficial interest in the Trust or the successor trusts beyond the period provided in the original terms of the Trust.

Accordingly, based on the facts submitted and the representations made, and provided the Court order is effective under State law and includes the modifications as described above, we conclude that the proposed modification and partition of the Trust will not cause the successor trusts to lose exempt status for generation-skipping transfer tax purposes, or otherwise be subject to Chapter 13.

Issue 3:

Section 2501 imposes a tax on the transfer of property by gift. Section 2511 provides that the tax imposed by § 2501 applies whether the transfer is in trust or otherwise, whether the gift is direct or indirect and whether the property is real or personal, tangible or intangible.

Section 2512(a) provides that, if a gift is made in property, the value thereof at the date of the gift shall be considered the amount of the gift. Section 2512(b) provides that where property is transferred for less than an adequate and full consideration in money or money's worth, then the amount by which the value of the property exceeded the value of the consideration is deemed a gift.

Under the modification and partition of the Trust, as discussed above, each beneficiary of the Child A Trust, the Child B Trust, and the Child C Trust will have an interest in the income and principal of that respective trust that is identical to the beneficiary's interest in the income and principal of the Trust created by the Settlor.

Accordingly, based on the facts submitted and the representations made, and provided the Court order includes the modifications as described above and the proposed partition is carried out and is effective under State law, we conclude that the proposed partition of the Trust into the Child A Trust, the Child B Trust, and the Child C Trust will not result in a transfer by any of the beneficiaries that is subject to federal gift tax under § 2501.

Except as specifically ruled herein, we express no opinion on the federal tax consequences of the proposed modifications and division under the cited provisions or under any other provisions of the Code.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Sincerely yours,

George Masnik
Chief Branch 4
Office of Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosure
Copy for § 6110 purposes